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# Difficult art of setting fees; Economics of accounting practice, bulletin 03

American Institute of Certified Public Accountants

Bulletin 3 ECONOMICS OF ACCOUNTING PRACTICE

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**American Institute of Certified Public Accountants**
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# 1. The Economic Background

THE FIRST BULLETIN in this series revealed that a disturbing number of CPAs in public practice are deriving incomes from their practices which are below any reasonable standard.

It disclosed, for example, that roughly one out of five practitioners are now receiving incomes which compare unfavorably with the salaries paid to staff accountants and accountants below the executive level in industry. An even higher proportion of the CPAs, moreover, are earning incomes which may not be sufficient to permit them to discharge all the basic obligations imposed upon professional men as a group and as individuals.

Since a professional man's income is a product of his fees, it is apparent that some CPAs must be charging rates for their services which do not accurately reflect the cost of performing those services.

This, in turn, raises some questions:

1. Do these practitioners include in their fees a reasonable amount for themselves as a legitimate expense in the conduct of a professional practice?

2. Do they maintain strict control over the time devoted to each engagement as a means of insuring that the proper levels of accounting skill are efficiently applied to it?

3. Do they lack a "resistance point" on fees – a constantly visible point at which a fee no longer recovers the full cost of an engagement?

4. Do they recognize that a professional fee can rarely be justified for non-professional work? And do they utilize non-professional assistants for work which cannot command professional fees?

5. Do they base their fee scale on a realistic estimate of the amount of "chargeable" time which can be expected of staff men and partners in a year?

If the approach of some CPAs to fee-setting is defective, it may well be due to the profession's reluctance to engage in open and candid discussions of the subject. To be sure, the old attitude of reserve is breaking down. Today, although a few CPAs still regard any outward expression of concern over fees as undignified, most members of the profession are ready to concede that a high quality of service cannot be provided unless the practice is functioning as an effective economic unit. Nonetheless, the old habit of reticence is not likely to be abandoned quickly.

This cannot, however, be held solely responsible for the fact that so little has been written on fees. The complexity of the subject has also discouraged practitioners from freely discussing it. There are, unhappily, no simple formulas and no universal answers in the determination of a fair fee. Too many elements – including subjective ones which defy precise measurement – enter into the decision. But one conclusion seems inescapable: in the light of the economic statistics contained in the first bulletin of this series, the difficult art of setting fees deserves far more attention than is generally accorded to it.

This study, based both on research in the existing literature on professional fees and on numerous interviews with successful practitioners, small and large, offers some guidance on the development of a sound fee schedule. But it would be successful if it achieved a more modest objective: to inspire a widespread exchange of ideas on the subject and thus improve the economic lot of all members of the profession.

## 2. The Factors in Determining Fees

### *The CPA's Tentative Income Goal*

Before a truly effective fee structure can be developed, an objective should be established against which the day-to-day performance can be measured.

This is represented by the practitioner's or partner's income target. The obligations which ought to be considered in selecting that target were discussed in the first bulletin of this series. A summary of them by Marquis G. Eaton, immediate past president of the Institute, is worth repeating:

> "The financial resources available to the professional man from his practice must be sufficient to enable him to do these things, among others: to pay the compensation necessary to attract to the profession, in competition with others, the highest type of young people; to maintain the library and other equipment needed in his work; to pay the cost of a respectable and comfortable office; to afford the leisure necessary for thought and study of an advanced character; to render the public services which the community may ask of him; to provide for old age; to discharge family obligations; to maintain a standard of living that would contribute to a client's good opinion rather than detract from it; to provide for his participation in the affairs of professional societies and attendance at their meetings. The practice should yield financial returns to cover these things without the burden of excessively long hours devoted to work . . ."

One of the considerations mentioned by Mr. Eaton merits additional emphasis. In setting his income goal, the practitioner would be well advised to keep in mind that his own evaluation of his worth can have a strong effect upon the client's opinion of his value. If he consistently underestimates it, the client may well underrate his abilities. This is a truism which applies to almost any human relationship.

"As a general rule," one expert on professional fees has written, "it is poor practice for the physician to undercharge. Certainly it is a psychological truth, evidenced in so many practical ways, that the man who undervalues himself loses caste in the eyes of the public. Often the large size of a man's fee increases his prestige and broadens his practice. If he charges an extremely moderate fee, however altruistic his underlying motive, the probability is that his patients will attribute it to his own lack of experience and ineptness. This is, of course, no brief for exorbitant fees; hence the wisest policy, especially when the doctor is new to the community, and his capabilities are largely a matter of conjecture, is to emulate the majority of local physicians in the fixing of a set charge."*

The selection of an income target, of course, is a wholly personal matter.

Accountants, first of all, vary greatly in ability. The CPA has attained professional status because, in addition to other things, the certificate represents a high level of competence within his field. It does not, however, guarantee anything more than minimal acceptable competence. Some practitioners, either through inclination, ability, or circumstances, may reach a technical plateau during the course of their careers which is not appreciably higher than the knowledge necessary to obtain the certificate. On the other hand, many CPAs regard the certificate as a mere starting point; they continue to broaden their knowledge and, through its proper application, increase their usefulness to the business community. Those who fail to keep pace with these professional leaders can hardly hope to match them in compensation.

In establishing his income goal, the practitioner must also take into consideration the nature of his services. If he is largely preoccupied with routine tasks which require no great exercise of

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* Wolf, George D., *The Physician's Business*, Second Edition, Philadelphia, J. B. Lippincott & Co., 1945, p. 115.

professional skill, he must realistically make an adjustment in his income expectations. But if his firm is primarily engaged in providing service at a truly professional level, he has a right to expect higher fees for its work. A professional service, after all, is a composite of many things. It is based on knowledge acquired through formal education, on experience gained in handling similar situations in the past, and on continual efforts to keep abreast of new developments. It demands an analytical ability which, combined with sound judgment, enables the practitioner to determine what work needs to be done and the most practical way of undertaking it. Such service quite properly carries a higher price tag.

As a guide in arriving at a reasonable figure, the practitioner must recognize that his net income should normally be composed of the following elements:

1. A realistic salary, equivalent perhaps to that required to hire someone to perform the practitioner's duties; or the salary the practitioner could expect to command if he was employed by another public accounting firm.

2. A return on the capital investment comparable to that which could be achieved if the money was otherwise invested.

3. A proprietary share – a reasonable amount which can be considered as the return to the principal for accepting the responsibility for conducting the practice. This represents the true profit of the accounting practice itself, for the other portions of the total net income generally can be realized without establishing or maintaining the practice.

For the sake of convenience, elsewhere in this study the word "salary" refers to both staff and principals unless otherwise noted; and the term "principals' return" refers only to the proprietary share plus the interest on the capital investment.

Finally, in deciding upon his income target, the practitioner should remember that clients expect a professional firm to be able to render competently any service within its acknowledged field. But the practitioner's level of fees affects his ability to render a variety of services of high quality. Consequently, if the fees charged by individual firms prevent its members from continuing to improve their capacities or interfere with the maintenance of an organization equipped to render effective services, the standards of the profession are lowered. Moreover, the fees of one firm are affected to some extent by the fees of others, with the quality of the services being determined, in part, by the extent to which the fee structure enables a firm to preserve high standards.

### *Fee Factors in Specific Engagements*

The income goal has an over-all effect upon the fee schedule; but a number of elements must always be weighed in establishing the charge for a particular engagement. Those most often mentioned by experienced CPAs and other professional men include:

1. Amount of staff and partner time devoted to the engagement.
2. Value to the client of the service rendered.
3. Technical importance of the work and amount of responsibility assumed by the CPA.
4. Difficulty of the engagement.
5. Ability of the client to pay.
6. Size and character of the community.
7. Established client vs. new or casual client.
8. Expense, including overhead and unusual expenses caused by the engagement.
9. Skill and experience of the staff members who undertake the work.
10. Acceptability of the fee to the client.
11. Urgency with which the work must be done.
12. Reputation of the accounting firm.
13. Customary fees within the community.

It is evident that these elements in setting fees fall into two basic groups:

1. Objective elements (direct expenses and time spent) which are the only ones capable of accurate measurement.

2. Subjective elements (most of which have some "value" or "acceptability" characteristic) which cannot be measured precisely.

In addition to the two basic categories, there are other factors which affect the upper and lower limits of the range of the fees which can be charged.

Opinion seems to be divided within the profession as to whether the first or second group should be emphasized in determining a fair fee for an engagement. Much of the literature in recent years has tended to dwell upon the "value" concept. No one, of course, would deny that a CPA's services have values which ought to be reflected in the fee. But a sound fee structure should be based on a hard core of measurable factors – and the "value" criteria is subject to a wide range of interpretations in any engagement. The "value" approach seems to have been advanced, in part, as an emulation of the practices of other professions. This, however, may have been the result of misunderstanding. While other professional men may seem to bill on the value of the work performed, they usually base their charges on an anticipated average hourly return. There is support for this view in the fact that articles have been appearing with increasing frequency in professional journals advocating the proper consideration of the measurable factor of time in order to practice on a sound financial basis.*

It is perhaps fruitless to argue which set of elements – the objective or the subjective – generally deserves the heavier emphasis. A close examination of them reveals that they are closely interrelated, rather than in conflict with each other. Yet it is worth underscoring the point again that only the objective elements can be accurately measured and controlled.

### *The Objective Elements in a Fee*

A fee *must* recover the direct expenses of the engagement, reimburse the firm for a fair proportion of its general operating expenses and provide some return for the principal. Otherwise, the firm cannot long survive.

Time is usually the biggest single element of cost. The time cost

* Among these are: "Do Your Fees Fully Reflect the Time You Spend?" by Arthur Owens, *Medical Economics,* September, 1957, pp. 122-126, 312-320; and "Fees That Are Fair to Your Patient and You," by Meyer M. Silverman, *Oral Hygiene,* January, 1952.

of the staff can be accurately computed from their salaries, payroll taxes, insurance and other employee expenses.

The determination of a principal's time cost is usually more arbitrary. Nonetheless, he should allocate a reasonable "salary" to himself as a basic cost of conducting a practice. The time and energy which he devotes to administering, planning and coordinating the staff operation is as much a cost of conducting a practice as staff salaries. The fact that he is the proprietor or a partner does not affect the validity of the cost. The practitioner is, in fact, one of his own most important creditors. A number of firms use the partners' drawing accounts as the cost figure and this, if set at a realistic level, seems to serve the purpose adequately.

How much of the time spent on an engagement should be charged to the client?

There is usually no question that the principals' and staff accountants' time should be included. Firms differ, however, in their treatment of their office and clerical help. Some regard typing and checking as a direct cost of the engagement and charge the client for them. Others absorb these costs in their overhead. According to recent surveys by several state societies, slightly more than half of the firms prefer the first method. The feeling seems to be that rising labor costs have made salaries of office help a significant item. Since the requirements of the clients vary, the cost should be distributed in proportion to the use of these employees. Time involved in research work connected with the engagement is usually included, but some firms make occasional adjustments in charging for these costs, when the knowledge gained might increase their capacity to serve other clients.

Expenses incurred during the course of an engagement – for example, out-of-town travel expense and long distance telephone calls – should be included in the bill. Most firms indicate major expenses as separate items on their invoices, feeling that they should be distinguished from "professional services rendered." A number of CPAs feel that all significant expenses which are directly related to an engagement should be charged to that particular client. This approach seems to be more in keeping with billing a client for work performed than it would if these items were included in overhead.

Most of the expenses which are not directly charged to the client are usually classified as overhead. This includes rent, taxes, telephone, insurance, library, supplies, depreciation of equipment and salaries of "non-productive" personnel. Ideally, the non-chargeable time of the principals, at their "salary" rate, should also be included in overhead. This overhead should be distributed among the clients as the cost of maintaining and keeping available an organization which can effectively render the services required of it.

The easiest method of allocating these expenses is derived from dividing the annual overhead expenses by the total number of hours charged to clients during the year by both staff and principals. This would give an hourly "burden" rate expressed in dollars which would be applied to each hour charged to a client during the course of an engagement. Like many simple methods, this one has its shortcomings. It enables the practitioner to recover his overhead costs; but those costs are not distributed among his clients according to the level of work performed for them. It follows that a client who is paying the same hourly "burden" rate, regardless of the staff grade employed, would be paying a much higher proportion of the overhead in a fee charged for the time of a junior than he would in the case of a partner.

Many firms believe that the amount of overhead charged to a client should vary in direct proportion to the level of work performed as well as to time. This is represented by the different grades of accountants used in the engagement. (The actual expense of a senior accountant is higher than that of a junior for several reasons — including the greater cost of the non-productive time of the higher salaried man.) By dividing the amount of overhead expense for the year by the gross annual salary costs charged to clients (i.e., the sum of each staff member's chargeable time multiplied by his "direct labor" costs), the "burden" rate is then expressed as a percentage. Calculating the value of the percentage for each individual (or the average for each class of staff man) and adding to it the salary rate, will yield the basic cost per hour. The overhead can then be figured for each engagement from the number of hours which are charged for each grade or individual assigned to the job.

This approach is by no means universal. Some firms feel that overhead cannot be allocated on an hourly or job basis, since any rate employed would be based on last year's figures, rather than on current ones. The volume of billing varies, while overhead remains relatively fixed. Consequently, unless gross fees can be very closely estimated, a "burden" rate cannot be applied accurately. These firms, therefore, set their fees on a basis which, over a year's time, will recover the total overhead expenses without trying to allocate them to each engagement.

It is evident that the only way in which these costs can be effectively met is through the employment of basic time rates established in relation to the direct salary costs of the engagement, or direct salary and an allocated portion of the overhead.

How much should these costs be in relation to the total amount billed?

It is impossible to answer this specifically. It depends on a number of factors including size of firm, its location (affecting rents and salaries), the nature of the work performed and, to some extent, the type of client. Nonetheless, the firms interviewed for this study indicated that certain ranges could be established. The consensus was that, except in highly unusual cases (e.g., a new client in an unfamiliar industry), direct salary costs should never exceed 50% of the fee. In most cases, depending on the services performed, the firms felt that the direct salary cost should average somewhere around 40% of the fee. Overhead expense exclusive of accountants' salary costs varied among them from a low of roughly 20% to over 40% of the gross fee. The most common range among these firms, as well as a number of other practitioners, seems to be 25-33%, with the lower end of the scale prevailing.

### *The Subjective Elements in a Fee*

Although the "value" elements within an engagement are almost impossible to measure, they remain in many cases important considerations in setting a fair fee.

They can include such things as amount of money involved, savings or convenience to the client, success or failure in attaining an objective, establishing a precedent or handling unusual problems. They are often closely related to the skill required to perform the work and the degree of responsibility assumed by the accountant. These elements of value to the client tend to fall into three groups:

1. Those that are reflected in a man's salary and receive proper consideration under a time-salary cost rate.

2. Those arising from technical accomplishments which are only partially reflected in the accountant's salary.

3. Those that bear little or no relation to the time involved.

In seeking a fair gauge to value, it is sometimes necessary to consider several of the value components simultaneously. When the various levels of the work involved can be matched to the appropriate skill of the individual staff members, the problem is simplified and proper scheduling can often achieve the proper evaluation. When this can be done thoroughly, it is often adequate to multiply the salary and overhead cost by the time involved, plus a reasonable charge for supervision and a contribution toward the principals' return.*

In many cases, however, the nature of the assignment or the limited size of the staff requires that each accountant perform duties which involve varying degrees of skill. Furthermore, as the scope of his talents broadens through experience, the accountant may be called upon to provide a wider range of services. Under these circumstances, an evaluation of the services based on the caliber of personnel assigned to perform them becomes more difficult. However, some of the firms interviewed did not consider this a serious problem. They usually do not make any downward adjustment in rates where a higher grade staff member performs duties usually assigned to a lower grade. They believe that the greater skill of the higher grade man enables him to do the job faster and better, thus offsetting the differential in rates. But it seems reasonable to assume that some routine assignments can be handled faster by a junior

* Defined on page 7 as the interest on capital and the proprietary share.

than by a partner because the junior has had more recent practice in repetitive tasks. A practitioner should be cautious, therefore, in billing for high grade men on lower grade work. In any case the client is likely to be more interested in what was done and how well it was done than who did it.

Some engagements are of such a nature that the time element and other costs are minor considerations. In a complicated tax settlement case, where thorough knowledge and judicious reasoning on the part of the accountant leads to substantial savings to the client, the accountant may well consider the amount of savings to be an important factor in setting his fee. As in all learned professions, circumstances arise where knowing what to do is of far greater significance than the physical execution of an act, which in itself might be relatively simple.

Under these conditions, the fee is often a result of personal judgment, weighing a number of factors, including the satisfaction of the client. For example –

A CPA represents two tax clients each requiring the same expenditure of time. One case results in a $5,000 tax refund and the other a $50,000 refund. Some accountants may feel that one case is considerably more valuable than the other, while others hold that the value to the client lies not so much in the actual financial result as it does in having someone represent his rights. His rights exist, regardless of the point of view. It might then boil down to a question of how clearly the client was entitled to a refund and the accountant's ability to make a persuasive presentation. Any way it is approached, a "reasonable" fee becomes a matter of opinion.

It is impossible to put absolute price tags on many of the subjective elements which are part and parcel of the services rendered, but the care with which these elements are weighed often represents the key to true professional pricing.

### *The Upper Limits on Fees*

Even after costs have been determined and the value of services have been properly evaluated, a fee is often restricted to a range whose upper and lower limits are affected by external elements. The effect of some of these can be modified by the practitioner; others are beyond his control.

First, the conditions, habits and customs of the community tend to impose a ceiling on fees. Because living expenses and operating costs are often less in the small cities, the general level of income might be somewhat lower. However, this differential diminishes rapidly when the community population is 100,000 or more. If a smaller community has a number of independent businesses, or has diversified industry, the limits are apt to be somewhat higher than a trading center primarily serving a farm area. These conditions are not absolute and tend to be localized without significant regional pattern. Moreover, some accountants have been able to overcome some of these limitations, as evidenced by the fact that some small town practices net as much or more than successful firms in large cities.

Variations in fees are to be expected from differences in the maturity and skill among the CPAs in the same area. A community expects a differential to exist between the talented, energetic and seasoned practitioner and his less skilled, aggressive and experienced colleague. In addition, a firm with a preeminent reputation may instill more confidence in a client than a relatively unknown one. The client may, therefore, rely more heavily on its recommendations and place greater value on them. Some businesses, especially small ones, may want to acquire prestige through employment of a CPA whose firm is highly regarded within the community. These variations tend to obviate adherence to the principle of "going rates" within a profession. Although "going rates" can affect accounting fees, the influence of them is less persuasive on firms of outstanding reputation. Truly professional fees should not, therefore, be fundamentally based on price competition.

Acceptability of the fee to the client is an important consideration. There is little point in rendering a bill unless the CPA can reasonably expect to collect it. The degree of acceptability, or satisfaction, can be influenced to a fairly large degree by the accounting firm itself, through continued high quality service and proven value to the client. When client education has been effectively conducted, resistance to reasonable fees can be greatly diminished or completely eliminated. (The techniques of overcoming client resistance and increasing acceptability is a subject in itself and will be examined in more detail in later studies.)

Irrespective of value, cost and even acceptability, there is a point at which the fair ability of the client to pay is reached – a limit to what a particular client can really afford to pay for accounting services. A number of practitioners contend that the CPA has an obligation to perform all of the services needed by small clients. However, if a client has a $2,000 limit on what he can fairly afford but the work required would cost $3,000 (including a fair return to the principals), the accountant would be operating at a loss if he undertook it for $2,000 – or providing a disservice if he charged $3,000. Very small businesses, in fact, must recognize that they cannot afford the best of anything. They often cannot afford the best offices, legal counsel, equipment or advertising media – nor the most comprehensive and expensive services a CPA can perform. A large company and a small one may have a problem whose solution requires substantially the same amount of work. In the first case, the solution may result in a $100,000 saving, in the second, $1,000. Because the costs of solving the problem may be well out of proportion to the results achieved in the latter case, the assignment ought not to be undertaken unless the CPA wishes to contribute a portion of his time for the welfare of the client, or can find a means of modifying his approach and still achieve the desired result. (He might, for example, set up the procedure to be used so that the client's own staff can perform the mechanics of the work.)

On the other hand, no business is so small or its ability to pay so limited that a careful diagnosis might not reveal opportunities for accounting services which could be useful at a fee scale which keeps in balance the value to the client, ability to pay and fair compensation for the time of the CPA. Some clients, for example, cannot afford to have a professional accountant keep their books. In many of these cases, an individual trained in bookkeeping can do an adequate job – and the client should pay no more than is justified by such work. If an accountant attempts to compete on a price basis under these conditions, he will doubtless fail to achieve a reasonable professional compensation. He might better devote his time to areas of greater usefulness. Nonetheless, rates at a professional level for some types of bookkeeping or write-up work can be justified if the accountant can do it faster and cheaper than a less skilled person — or the additional skill employed results in a better job which is worth more to the client. But this assumes that additional value is in keeping with the client's ability to pay for it.

Even if a CPA could charge whatever he wished and a client was willing and able to pay it, there is a self-imposed limit inherent in a professional fee. A professional man is not entitled to unlimited earnings, for at some point his own services, no matter how well performed, cease to have additional value. Although the point at which this may occur is nebulous (perhaps because so few CPAs may have reached it), there is at least a theoretical level in acquiring wealth through professional practice at which service gives way to profit as the primary consideration.

### *The Lower Limits on Fees*

It is generally held that a laborer is worthy of his hire and that a professsional man should expect and is entitled to a professional income for professional services.

As mentioned previously, a reasonable salary for the principals of a firm is as much an element of cost as those of the staff, rent, supplies, or equipment. On this basis it can be said that the bottom limit of a fee structure must be such that the annual fees cover annual costs.

There are several theories on the flow of costs, developed with varying degrees of logic. The common one seems to be that costs flow from one engagement to another. This, in turn, is usually based on one of two assumptions.

The simpler and probably the more widely employed is that costs become attached to an engagement by the number of man-hours (within each grade) assigned to the engagement. This method furnishes a control point in the management of the practice which serves as a guide in the day-to-day problems of practice. It is useful in making decisions on:

1. The work which a client can afford to have done for him, where there is a close limit on his ability to pay.

2. The management of chargeable and non-chargeable time within the accounting firm.

3. The minimum fees which can be accepted for any engagement for any client.

The third area has special significance in that it provides a built-in "resistance point." The practitioner will know that if the fee for an engagement does not recover this amount, it will subtract from the proposed annual financial result. This doesn't mean that an engagement should never be undertaken for less. But by having what amounts to almost day-to-day control, this point is always visible to the practitioner. If he does not know where this point is, he will not know the level at which he should offer strong resistance to pressure for a lower fee. The use of the objectively measurable element of time is the only way in which this control can be maintained.

The other assumption, which is sometimes used, is that the cost flow is related to the value of each engagement. This requires that the fee involved be measured against the annual costs and fees, without any day-to-day control. The difficulty in this approach is that there is really no sound way (without the use of time) to determine how much a particular fee should be in relation to the total annual fees.

### *The Application of Cost Flow*

How then is the flow-of-costs principle applied to the fee to be rendered?

An annual income result presupposes a certain number of hours which are to be charged to the clients. To these hours are applied the rates which will yield the desired return. The number of hours can be determined by the performance standard of the firm, for the different grades of accountants employed.

Since practicing accountants seem to work longer hours than other occupational groups, an attempt was made to determine what number of chargeable hours was reasonable or desirable. Although no precise figure can be cited, some guides can be established.

An article in *Fortune* magazine* indicated that management consulting firms base charges for their staff on a supposition of 150 days (1050 hours) a year. The nature of their services is often non-repetitive and once a particular assignment is over, they must turn to new clients. It has also been said that 1,000 chargeable hours represents the optimum productive time in operating on patients (200 days at five productive hours per day) in a busy dental practice.†

Accounting firms, on the other hand, usually have a large portion of repetitive clients for whom the work remains relatively constant. Since they can forecast and plan their work more accurately, there are apt to be fewer and shorter gaps between assignments for the staff. Therefore, accounting firms can be expected to have a higher percentage of chargeable time than consultants. Assuming that overtime is undesirable, there may be about 1,800 hours a year (after deduction for vacations, holidays, sick time, etc.) which is theoretically available for each man. Since almost no one can be involved in chargeable work all of the time, the chargeable time standard should be less than this. Some firms, both large and small, feel that approximately 1,400 hours a year (200 seven hour days) represent a sound estimate of a reasonable number of chargeable hours upon which to base staff rates (they felt possible overtime work should not be considered in the base) – with the partners having somewhat less, depending on their administrative and other duties. Other firms consulted for this study believed that 1,600 hours might be achieved without the use of overtime. A member of a large multi-office firm stated that, while 2,000 hours represented an ideal, the actual performance of the staff was about 80% of the ideal – with roughly 60% of the time for beginning juniors and partners being classified as chargeable. This situation was con-

* "The Ambitious Consultants" by Perrin Stryker. *Fortune,* May, 1954. p. 184.
† Op. cit.

firmed by several firms of comparable size, whose average of 1,600 annual chargeable hours included overtime.

Some variation also exists among firms due to the length of the work week. In large cities, a number of firms operate on a 35-hour week, others work 37½ or as much as 40 hours in a regular week.

After a realistic chargeable time standard is established (bearing in mind that sufficient time should be available for personal development, staff training and other professional activities), salary and other costs can be computed and basic rates determined. There is evidence that some firms do not figure the direct salary cost in a way which lends itself to effective control. The hourly direct salary cost chargeable to a client for an $8,000-a-year man, for example, is not four dollars (based on the 2,000-hour year for which he is employed), but five dollars on the basis of his chargeable time (assumed to be 1,600 hours in this case). The firms who compute the salary cost on 2,000 hours usually allocate the non-chargeable time to general overhead; but in doing so they may lose control unless they recognize that non-chargeable time is a cost which should be recovered on a day-to-day basis.

Since the basic rates are established to achieve a particular income result over a given number of hours, a firm's income will be increased if its experience exceeds those hours – and if its basic rates were actually billed and costs did not rise (e.g., overtime pay). On the other hand, if the estimated financial result can be achieved only through exceptionally long hours, either the fee schedule or the expected income return requires some modifications.

A regular fee base is computed on several assumptions which, when not adhered to, may require some changes. These assumptions include:

1. That regular work is being performed for regular clients. When a non-repetitive engagement from a casual client is accepted, a higher rate may be justified, since the flow of costs is different and the regular base rate may not have sufficiently allowed for such circumstances. On the other hand, experience with a regular client might suggest that economies could be instituted at times (e.g.,

a man might be assigned full time to a large client) which would permit the accountant to charge less per hour, without affecting the estimated annual income result. This doesn't imply that a lesser rate *should* be billed under these conditions, but only that it is possible, under certain circumstances, to charge a lesser rate which will not affect the annual income expectation.

2. That the work will be handled efficiently. If the costs are raised through the accountant's fault, inexperienced help, inadequate supervision, false starts, or doing work which shouldn't have been done, he should bear the increased cost himself. This means the fee would be something less than the extension of the base rate.

3. That the various accountants involved in an engagement will be assigned "in grade." If a man is assigned to work which can be adequately handled by a lower grade accountant, a downward adjustment might be in order. This, however, is not necessarily true. If a senior can do a job faster than a junior, the fee would be no more, even at higher rates. If he can do a better job and the additional value is significant, he might even justify a higher fee.

## 3. Types of Fees in Current Use

Over the years a number of articles have been written advancing the relative merits of per diem (or hourly) fees and contract fees, represented by flat fees and retainers. Actually, their differences lie not so much in their being different *types* of fees but in their being different approaches to dealing with clients. Both are usually based on a computation of time. In the first case, the bill is figured from an extension of the time spent, multiplied by a standard rate. The latter is an attempt to estimate the time involved, applying the standard rate to the estimate and quoting a fee to a client in advance of an engagement. In current practice, only a minority of the firms and practitioners seem to use one approach to the complete exclusion of the other or use either one in strict accordance to their traditional definitions. A third type of fee, also based on time, is some variation of a costing method.

In order to better understand the modifications which have evolved, a brief description of the merits of these approaches may be in order.

### *The "Costing" Method*

One of the traditional methods of establishing a fee involves separate computations of the components of a fee and does not attempt to integrate them until the bill is prepared. In a simplified form it can be expressed as:

Fee = A + B + C – where A = the product of the hours involved and the hourly salary cost (staff and principals); B = an overhead allocation; and C= principals' return, usually based on a percentage of the sum of A and B.

Although this method is still used by some firms, it involves extensive calculations in preparing bills. Many firms feel that this additional work is not necessary, for if the flow of costs is established by time spent, all costs (not just salary) should be applied when extending time. This gave rise to the use of hourly or per diem rates, which give due consideration to most of the elements of a proper fee.

### *Per Diem Rates*

These are charges made in direct proportion to the actual time spent on an engagement. The rates themselves usually vary according to the grade of the personnel who perform the work. In small offices, each accountant may have an individual rate, but a more common practice is to average them in accordance with the classifications of junior, semi-senior, senior, supervisor and principal. The rate is derived from the average salary cost for each classification, to which is added an amount to cover a proportion of the overhead and "principals' return" compensation for the partners. The client is billed on the basis of these rates multiplied by the amount of time spent by the accountants within each classification.

It has been found in practice that several formulas yield a return which adequately covers these factors in different practices. The most frequent ones mentioned range from two to three times the direct salary cost (based on the estimated annual chargeable time), with two and one half tending to predominate. Another method is to bill the daily rate at one percent of the annual salary cost.

There has been a tendency on the part of some firms to accept one of these formulas as the "going" rate within the profession. The lack of comparability of these formulas lies in the failure to consider the varying methods used by different firms in considering the components of the rate. Two times the direct salary cost may be an entirely adequate rate for a firm which charges a client directly for the time of typists or other clerical help and other items which can be specifically associated with the engagement. But another firm which absorbs all clerical costs and other direct expenses as overhead might find that a rate of three times the direct salary cost is needed to achieve a satisfactory return. Variations in rent and other costs also affect the amount of overhead of different firms and thereby, the size of the multiplier which is sufficient to consider them. In addition, different estimates of the number of chargeable hours per year are used to determine the salary cost. If the same formula was applied on an hourly or daily basis in these cases, therefore, the rates would be different. However, if two men in different firms at the same salary each met his performance standard, the amount of fee produced during the year would be identical – the difference being in the flow of costs, since one requires more chargeable time to produce the same annual results.

When rates of this type are employed, it is usually better to establish them on an hourly rather than daily basis for two reasons: the length of a day is often open to varying interpretations, and the charges for a fraction of a day are more difficult to distribute than smaller units of time.

The advantages of a straight time rate, according to its advocates, are: (1) the client pays for exactly what he gets in the way of work performed, no more and no less; and (2) the accountant is assured of avoiding a loss on an engagement by receiving full payment for time devoted to work.

But this fee arrangement also has one important disadvantage: it places, under certain conditions, undue emphasis upon the time element. It may not be flexible enough, even with proper scheduling of staff grades, to consider the quality or value of the services. Nor does it always take into consideration the highest forms of professional service, where time has little significance as a measure of value. Since a client has no real idea of what the services will cost him, he sometimes cannot decide if certain services are worth the price he may have to pay for them. Under these conditions, he may limit himself to the minimum service without realizing that additional service could be of greater value to him in the long run. Whenever this might be a problem, some firms keep their clients informed of the charges by advising them as the costs reach certain levels.

*Flat Fees and Retainers*

An agreement to perform any or all services for a specified fee has sometimes been represented as the truly professional basis for billing, for the client is aware of the cost before the engagement is undertaken.

The traditional concept of a retainer (still prevalent in England) was that, for a given sum, a professional man would guarantee that his services would be available if needed. There would be an additional charge for the costs of any services actually rendered. As used in this country, the retainer differs from the usual fixed fee only in that it is an agreement to perform these services for a designated period of time.

Therefore, for all practical purposes of analysis, the two forms of contract fees may be regarded as one.

The biggest single disadvantage to a fixed fee is that it is just exactly that – fixed. If an accountant underestimates his costs, or new facts uncovered in an engagement add to them, he may not receive an adequate return for the work performed, or may even lose money. Moreover, in a period of rising costs it may be even more difficult than in the case of per diem rates to persuade a client to accept an upward adjustment in a fixed fee or even acknowledge the value to him of additional services which may have required more time.

On the other hand, the client may suffer if the accountant overestimates his fee. The usual practice in setting a fixed fee is for the accountant to undertake the difficult task of estimating the time involved, apply per diem rates and add a percentage for contingencies. The client is then overcharged to the extent that the contingent factors do not materialize as allowed for in the estimate.

Firms differ in their views of the fixed fee. Some, especially those caught in the price squeeze arising from the spiralling costs since World War II, are adamantly opposed to them in any form. Yet a recent survey by the Institute of more than 2,100 firms and practitioners showed that over 75% had *some* clients on a fixed fee basis. This percentage remained fairly constant throughout the various regions of the country. The population of the community did not affect the results appreciably, although a slightly higher percentage of the firms in large cities indicated they had some clients in this category. Nor was the fixed fee characteristic of the smaller firm. Although the smaller firms may tend to have a larger volume of clients in this category (the number or percent of a firm's fixed-fee clients was not determined in this survey), over 70% of the large firms had at least one such client. (See appendix, page 51 for details.)

The widespread use of flat fees, under certain circumstances, indicates that they can sometimes be effective if suitable precautions are taken.

The first of these precautions is that a fixed fee arrangement should only be undertaken for established clients whose accounting needs are fully understood. Secondly, the services should be expressly limited and the fee should be for a designated period of time (a retainer), subject to review at the end of this period. This approach has been presented by Max Block* as follows:

> 1. The retainer when used should cover services that are reasonably predictable as to volume and complexity. In this category, generally, are the following:
>
> a. auditing
> b. financial statement preparation
> c. preparations of tax returns – covering routine business transactions
> d. review of reports and tax returns with clients
>
> 2. By excluding the non-predictable items, the retainer can be made less speculative . . .
>
> 3. Non-retainer items should be billed separately when, as, and if the services are performed. . . . Services included in this category, patently, are those not covered by the retainer. The following are illustrations of such services:
>
> Extraordinary tax planning
> Attendance at tax examinations except, perhaps, when only minor problems develop

* "Office and Staff Management," a forum conducted by Max Block, *The New York Certified Public Accountant,* March, 1952. pp. 191-194.

Conferences on a high level, not dealing directly with financial statements and tax returns prepared
Special investigations, etc.

4. In order that a client should not receive too many bills, non-retainer items might be billed semi-annually, or even annually.

5. In any event, clients should be advised that it is not intended under a retainer arrangement that unlimited services be rendered for a limited fee. This should be understandable by a fair-minded businessman and, if necessary, his own business operations might be used for illustrating the propriety of this point. Thus, even where routine services are involved, should it happen that because of sharply increased business volume, or because of difficulties within the client's own organization, the annual retainer is substantially inadequate, "renegotiation" of the retainer should be possible and a year-end adjustment be provided for . . .

### *Contingent Fee Arrangements*

When all or a substantial portion of a fee is paid only if a given event occurs, it is usually referred to as a contingent fee. It is generally expressed as a percentage of the amount which is "saved" or "won" for the client.

Although it is generally recognized that such an arrangement has no place in accounting and auditing work in general, it is sometimes difficult to determine the line of demarcation between contingent fees and fees which are justifiably determined after the work is completed and the benefits to the client are considered. "The test to apply," says John L. Carey, "is whether, by prearrangement, the certified public accountant has what amounts to a financial interest in a venture of his client, in that the CPA may receive an *exceptional* financial reward, contingent upon the success of the venture. This kind of prearrangement is improper because it may influence the accountant's judgment (or 'findings'), or subject him to the suspicion that his independence has been impaired."*

The Institute's Rules of Professional Conduct do not prohibit performing tax work on a contingent basis "where the findings are

* *Professional Ethics of Certified Public Accountants,* John L. Carey, American Institute of Certified Public Accountants, 1956.

those of the tax authorities and not those of the accountant." The Treasury Department, however, requires the filing of a signed statement containing the terms of the compensation agreement if it is on a wholly or partially contingent basis. Furthermore, it prohibits wholly contingent fees unless the client could not otherwise afford to obtain the services. Partially contingent fees are permitted by the Treasury Department if "provision is made for the payment of a minimum fee, substantial in relation to the possible maximum fee, which minimum fee is to be paid and retained irrespective of the outcome of the proceeding."†

### *Minimum-Maximum Estimates*

In an effort to satisfy clients who insist on having an estimate of costs in advance of an engagement, some accountants will give a probable range.

After estimating the time involved at the rates usually charged for similar work, the accountant may present the total to the client as the minimum charge. To this he may add an amount which he feels is something in excess of all possible contingencies. He may bracket his estimate rather than using it as a minimum, but it is usually advisable to err on the high rather than the low side. Few clients have ever been known to complain if their bill runs less than the estimate. The more complex the engagement, the greater this amount should be. The estimate could then be presented as a bracket, wide enough to consider possible complications which may arise.

As is true with most compromises, this method leaves something to be desired. It does, however, provide the client with some idea of the probable fee, while furnishing the accountant with a hedge against unforeseen developments. When it is possible for the CPA to make a preliminary survey of the work to be performed, it reduces the amount of guesswork which would otherwise be involved. Some firms usually charge for such surveys.

An alternative to this procedure, used by some firms, is to tell the client the per diem rates which would normally apply and then

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† Treasury Department Circular No. 230, Sec. 10.2 (4) (y)

roughly approximate the time involved. This system enables the client to estimate, to a limited degree, the cost of other services which he might wish to add, but it makes it difficult for the accountant to vary rates to adjust for application of greater than "normal" skill within a staff classification which might be justified after the engagement is underway – or to give consideration to the additional value of the services which might be developed during the course of the engagement. Moreover, a number of successful firms object to this practice. They feel that quoting of hourly or daily rates is more in keeping with the relatively constant skill level of the artisan than the wide range of abilities required of the professional man. This approach, in their view, detracts from their status in the eyes of their clients.

When a CPA feels that it is necessary to make an estimate, other than for the limited services for which he may feel confident in quoting a fixed fee, the minimum-maximum dollar estimate seems to be the preferable choice.

### *Straight Time With Adjustments*

A common practice is to extend the time of each class of accountant at basic rates and have the summary sheet examined by the principal most directly concerned with the engagement. The principal reviews the time and considers any extenuating circumstances. He may compare it with former bills to the client, if the services are similar, and attempt to account for discrepancies. He strives to assign a dollar value to the unusual elements of the work performed and the benefit to the client. He may then make some adjustment either upward (e.g., extensive contributions to improving internal procedures or large savings to the client in a complicated tax settlement) or downward (e.g., inexperienced personnel) to achieve what he feels is an equitable fee for "professional services rendered."

This method seems to be used by sole practitioners and large firms alike. In long, complex engagements, however, a number of valuable contributions may have been made in which the time involved bore no significant relation to the intrinsic value. The important reorganization conference appears on the time sheet as 30 minutes, the valuable piece of business advice delivered on the telephone appears as 15 minutes (if it appears at all). Unless the "description" line on the time sheet is truly descriptive, it may be inadequate as a basis for determining the value of the work. Partially offsetting this, of course, is the fact that the greatest degree and variety of skill employed in the engagement and the major consultative contributions are often made by the man who makes the final billing decisions.

### *The Variable Scale*

In an effort to keep the value of the time element in its proper perspective during the course of an engagement, a number of firms have adopted a *range* of rates within each classification of accountant. This differs from straight time with adjustments in that the adjustments take place during the course of the engagement and are considered in the hourly rate itself. Through the application of a rate most nearly related to the skill required of the individual, the firms which use this procedure believe that it reduces end-of-job adjustments and simplifies the billing process.

The higher the classification, the wider the range of possible rates, due to the wider range of abilities the accountant may be called upon to utilize.

In a letter to the Institute advocating a variable rate structure for most billing situations, Dixon Fagerberg* says:

> Averaging of rates is inevitable in both theory and practice, since the execution of virtually any engagement comprises a series of tasks calling for varying degrees of education, skill and experience. This is because, as a practical matter continuity of thought is required, so there are natural limits to the division of a five-task assignment among five persons so as to utilize the highest skill of each.
>
> Notwithstanding, the larger the office staff and/or the engagement, the greater the possible subdivision of skill levels and the greater the potentialities of using lower skills on more routine phases and higher

* Mr. Fagerberg is the former editor of the Practitioner's Forum in the *Journal of Accountancy* and has made significant contributions to the field of practice management.

skills on more important and difficult phases of a given engagement. In general, the smaller the engagement the greater the averaging of the skills of the one man or two men performing it. The larger the engagement the less the overlapping of subdivided skills, hence the greater validity of fairly uniform standard rates (really average or composite-skill rates) by gradations from junior to light senior to heavy senior to supervisor to principal.

The closer the approach to the apex of the organization, the greater the possible variability in rates. There are many jobs or parts of jobs the young junior cannot be trusted with at all. On the other hand, circumstances (busy season, deadlines, etc.) not infrequently make it necessary for the top man to do work far below his highest skill, which he can do no better, and perhaps not as fast, as one of the semi-seniors, in which case the client can and should only be charged accordingly.

It is often difficult to determine which rate within a staff classification should apply, especially when the possible range is rather wide. The solution advanced by a number of firms is to establish some benchmarks within the scale, resulting in perhaps several rates within a classification.

Sproull† suggests three scales which he calls the Simple Audit Scale, Other Audits and Tax Scale, and Complicated Scale. Regarding the Simple Audit Scale as the minimum rate within a staff classification, he establishes the rates for the Other Auditing-Tax Scale and the Complicated Scale as 150% and 200% and up, respectively, in their relation to the minimum rate.

T. Dwight Williams‡ reports the results of a survey on adjustments for types of services, as follows: "To obtain upgraded rates for services of a nature other than routine auditing, most firms increase their basic rates by some percentage.

"For tax services, the reported percentage of increase ranges from 25% to 100% and averages about 60%. For systems installation, the percentage of increase varies from 10% to 100% and averages about 40%. For special investigations, the range of in-

† *Accountants' Fees and Profits* by R. Sproull, London, Professional & Trade Books, Ltd., 1951.

‡ "Fees for Services," T. Dwight Williams, *CPA Handbook,* New York, American Institute of Certified Public Accountants, 1953. Vol. 1, Ch. 12.

crease is from 10% to 100% and averages about 50%. For advisory and consultative services, the range is from 25% to 150% and the average about 66⅔%."

It is impossible to define exactly the types of work which would fall within each rate when a variable scale is used, due to the variations inherent in each assignment. The proponents of this method, however, feel that, with an understanding of the principles involved, a practitioner should be able to evaluate most assignments and assign a rate reflecting the average level of work performed. For engagements where time remains a major element, an increasing number of firms, especially the smaller ones, where each individual is called upon to handle a variety of assignments, have adopted some form of variable scale with which to evaluate their services.

If a firm employs a variable rate structure, it should still establish a "minimum" or "average" rate for each staff classification, designed to cover all costs (including a fair compensation to the principal). Unless such rates are set up, at least as a guide, the practitioner will not be able to relate his financial position to the specific engagements and will lose effective control over his efforts to achieve his desired annual income result.

### *Consulting Fees*

In cases where time is not really pertinent to the "value" of services rendered, none of the foregoing practices are really effective. These situations arise at the higher levels, generally in the case of a principal. Here the elements of value and the degree to which the practitioner must draw upon his professional training are often the only major considerations in determining the fee. Although some practitioners will bill these services at twice their "standard" rate, there are circumstances under which this is also inadequate. Conferences to which he has made substantial contributions; advice about complicated business problems; negotiation of tax settlements are examples of this type of work. A "consulting" fee is mentioned not because it represents a method of setting fees, but it is indicative of situations occurring with varying frequency, for which a practitioner must make provision to arrive at a proper fee.

Up to this point this bulletin has been concerned with the pros and cons of different approaches to fee setting, in the light of the factors which are widely considered to have a bearing on the fees.

It appears from the foregoing that there is no one right method of setting fees. It is entirely possible that each method might result in a proper fee, under certain circumstances, not only as they are applied by different firms, but within a single firm as well. Different situations may require different treatment, but the basic principle remains the same: although value of service rendered should be the criterion for any professional accounting fee, value itself is in large measure based on the costs of rendering the service.

# 4. Current Practices in Fees

To what extent is the profession as a whole giving the proper weight to realistic costs which include a fair "salary" to the principal, and a reasonable return on the proprietor's equity?

Too little statistical material has been compiled to justify many sound conclusions about the general practice of the profession in setting fees. From the available literature, however, several tentative generalizations may be attempted.

1. Many firms rely heavily on billing at a rigid time rate or a lump sum based on such a rate, although some of them have not been based on a realistic evaluation of the factors involved.

2. There is some trend, however, toward a more flexible fee structure, in an effort to give consideration to elements of value and the level of work performed.

3. There is a tendency to use different rates for different types of services, notably auditing, tax work and management services.

4. There is less reluctance among accounting firms in having full and frank fee discussion with the client.

### *Survey Results on the Basis for Setting Fees*

Eighty-five per cent of the over 2,100 accounting offices replying to a nationwide survey by the Institute, indicated that time spent was a fundamental consideration in setting their fees. (See page 54 for analysis.) Of these offices about 52% of them stated that their fee (with the exception of tax work) was usually an extension of a straight time rate. Of this group more than half of them used special rates for tax work. The other 47% of the offices where time was the primary factor, indicated that the majority of their bills contained some sort of an adjustment from a straight time rate, for the circumstances surrounding the engagement.

The 15% surveyed who did not feel that time was generally the primary consideration in their usual fee, stated that the size of their fee depended on the nature of the engagement and its circumstances.

Since these figures may have been somewhat distorted by the high proportion of replies from small firms who were apt to limit their practices to auditing and tax work only, a series of personal interviews were conducted with a number of representative firms, large multi-office organizations and small practitioners. Virtually all of them said that in engagements requiring a relatively constant level of ability by the men involved, or where the nature of the work lent itself to distribution among appropriate members of the staff according to the skill required – the fees did not vary materially from the "basic" rate for the classification involved. (See pages 47-50 for examples of conditions under which adjustments were made.)

### *The Limitations of Fee Surveys*

The value of fee surveys as being indicative of general billing rates has been questioned by some practicing CPAs, while upheld by others. One of the arguments against such studies is that even if a "going" rate could be established for different services, it wouldn't be of too much help. They argue that accountants' fees are too low to start with and that these averages might tend to become the maximum fees in that area. They feel it is of more importance to know what the successful firms are charging, rather than the typical. The fact that different firms use different bases in determining their rates and that varying degrees of adjustments take place before the bill goes out, tend to limit further their value. Little control is usually exercised over the replies and the number of returns is generally not statistically valid in relation to the group it purports to study. On the other hand, proponents of such surveys feel that many practitioners have little or no idea of the rate structures within the other firms in the community. Therefore, they have difficulty in evaluating their own fees. Firms with the lowest rates, they say, are encouraged by these surveys to raise the level of their fees to a point which is more in keeping with the general practice in the locality. They also provide a guide for the use of new entrants into the profession, or the community.

Some state societies and chapters have conducted fee surveys during the last few years. While averages derived from them are of limited value, their most important contribution often lies in pointing up the extremely wide range of fees which exists among firms in similar locations, doing similar work. One recent study showed a range among principals of $5-$25 an hour for similar work – under certain circumstances $50 an hour constituted the upper limit of the range for special engagements.

A certain amount of the spread can be attributed to varying degrees of ability, type of work and the depth with which the CPA goes into a client's problems. The only answer, however, which can account for a good deal of it, is that the practitioners at the lower end of the scale are either grossly undervaluing their services, or are performing services which are of a clerical rather than professional nature.

Since fees are dependent on so many factors and computed from different bases, it is difficult to compare the fees of one firm against those of another.

However, if the practitioner is aware of the circumstances existing in other firms, their size and nature of practice, he is in a better position to make such a comparison. With this in mind, eighteen members of successful local firms were asked to describe the methods they use in arriving at their fees and the relationship of salaries and overhead expense to their gross billings. Their descriptions are not necessarily typical of general practices, but they are indicative of successful approaches which have been used by some highly regarded firms.

All of them stated that they used some sort of computation of time and rate as a foundation for their billing. However, the importance of straight time to the fee itself varied among the firms.

The value to the client of the services rendered and the type of work performed were almost universally regarded as an important element, but varying means of considering it were used. Some of the firms make rather arbitrary adjustments in the bill while others, especially those with large staffs, felt that they were able to weigh these factors sufficiently through the proper scheduling of work among the different grades of staff men, who in turn had different rates, depending on their experience and ability.

In these cases rates for each grade of staff man tended to be somewhat flexible. Some of the representative approaches are described on pages 41-46.

# 5. Summary and Conclusions

After reviewing the published material on fees, as well as the frank observations of a number of successful practitioners, several conclusions seem in order:

1. Although the setting of a proper professional fee is, in the words of this booklet's title, a difficult art, too many practitioners devote too little time to the task. They are inclined to rely upon formulas which seldom reflect all of the costs of operating a professional practice. One of the most significant of these costs is the annual income which a professional man has a right to expect from his practice. Yet relatively few CPAs – and the few are generally the successful ones – make a determined effort to establish this income goal and to design their fee schedule to produce it.

2. Time devoted to an engagement can be a useful gauge in setting a fee for it – if certain conditions are met. First of all, the men assigned to the engagement must be assigned "in grade" – that is, the salary cost of each of them should be closely related to the expected value of their contribution to the engagement. The work, too, must be closely supervised to avoid a dissipation of effort in the detours and dead-ends which can occur in many engagements. Finally, the billing rates must be based on realistic estimates of the number of productive hours which can be expected of each man. If any of these conditions are not met, the "time" yardstick in billing can be a trap for the unwary – leading to one of two undesirable results: the client is overcharged, or the CPA is underpaid.

3. There are other circumstances, moreover, when time alone must be a highly defective measurement of service. In these cases, a reasonable fee can be determined only through a subjective evaluation of the skill and technical knowledge required to perform the needed services — and of the results to be attained in rendering them. Of course, this evaluation might occur when various levels of staff men were assigned to the engagement in grade — and thus the time factor could conceivably provide a fair standard for billing purposes. More often, however, the evaluation can be better undertaken at the completion of the engagement when all of the factors are clearly known.

4. As a matter of policy, some accounting firms decline any engagement which will not warrant charging rates which will at least recover their full costs and thus enable them to maintain an office equipped to render high quality service. Although experiences with costs and chargeable time differ among firms, individual basic rates usually can be derived from the application of two propositions: (a) direct "labor" cost is the ratio between annual salary and annual chargeable hours; and (b) direct "labor" cost should not exceed 50% of the fee (no firm interviewed felt it should be more, and some felt it normally should be less). Under these conditions, for example, a $6,000-a-year staff man who could be expected on the basis of experience to produce 1,600 hours of chargeable time would have a salary cost of $3.75 per hour, requiring an hourly billing rate of at least $7.50. If his record indicated that 1,400 chargeable hours was a more realistic estimate, the direct "labor" would cost $4.29 per hour with a minimum rate of $8.60.

5. Basic rates, when once established on a sound basis, provide a control point in the day-to-day management of a practice. Naturally, specific engagements may require adjustments from the rates; but the practitioner, knowing that he must average these rates over the year if he is to achieve his income goal, will be aware of the impact of every departure from his "standard" charges. He will, in other words, have built into his practice a "point of resistance" to the pressure for lower fees.

6. Since value to the client is a vital element in the acceptability of a fee, accountants cannot command a professional fee unless they render a truly professional service. The CPA certificate in itself cannot establish the level of fees. It merely indicates a certain degree of competence. The heart of the matter is whether that competence has been delivered to the client – and whether the client is fully aware of its delivery.

The subject of gaining client acceptance is beyond the scope of this brief study. It will be considered, however, in a future bulletin.

This present study has tried to provide some guidance on many of the problems which arise in establishing reasonable fees. It has not answered one question: how much should a fee be? The reason for this is obvious: there simply is no single answer to that question.

But it is hoped that this bulletin has offered some insights into the underlying factors in fee setting – and that this background information, coupled with the descriptions of the methods used by successful firms, will enable the practitioner to arrive at fees in keeping with the circumstances peculiar to his own practice.

Even if it only provokes forthright discussions of the subject, however, it will have done a good deal. For these discussions, in turn, are certain to encourage more practitioners to devote the time necessary to mastering the difficult art of setting professional fees – fees which will fairly reflect the value of their services and the full cost of performing them.

## Case Studies in Fee Setting

THE FIVE CASE STUDIES outlined below are representative of the rate structures employed by the 22 highly regarded firms who were personally interviewed about their fees.

These firms are located from coast to coast in communities ranging in population from less than 15,000 to the largest cities in the country. Although their fee practices are not necessarily representative of the profession, they are indicative of the situations existing in a number of successful firms.

No significant variations in rates among these firms could be attributed primarily to either the size of the firm or community. Although the upper range of partners' rates was higher in the major cities in some cases, the usual rates for both partners and staff were well distributed among all sizes. As a matter of fact, the lowest rates were charged by a three-partner firm in a large eastern city, while the rates of an individual practitioner in a small midwestern town were among the highest. This may seem to indicate that, among successful firms, the experience and ability of the individual and the reputation of the firm can enable a firm to overcome lower fee levels which may sometimes be associated with geography or the size of the city in which the practice is conducted.

### *Bills Clients at "Cost"*

Each individual in this firm of five partners and 25 staff men has his own rate and an extension of the time involved at the standard rate is usually the fee rendered. Except for tax work, adjustments, either up or down, are relatively rare and occur in less than 10% of the cases.

This firm reasons that if a fair and reasonable compensation to the partners is acknowledged as a cost their standard rates represent the cost of providing service. The client should pay these costs, unless the firm is at fault. If unnecessary time is consumed or poor scheduling of manpower is involved, this firm considers these conditions to be results of its inadequate management, and feels the additional costs should be absorbed by the firm. On the other hand, if a staff man makes a significant technical contribution not normally expected from his grade, an upward adjustment is sometimes made. In most cases, however, "value" is taken into consideration by taking pains to schedule the work so the staff men are engaged in work normally performed within their respective grades.

The rates used are a product of twice the direct salary costs, which are figured on an annual chargeable time standard of 200 seven hour days. Although the actual performance sometimes exceeds 1,400 hours, the firm feels this is a realistic yardstick to use. On this basis, the day rate works out to be one per cent of the annual salary, and the rate is easily applied to the salary with a minimum amount of computation. Close control is maintained to see that these rates are billed, on the average, during the course of the year.

Examples of the hourly rates within the firm derived from this and rounded off are: Junior (@ $4,800), $7.00; Senior (@ $8,000), $11.50. Rates for the partners, depending on their age and experience, range from about $15 to $25 an hour.

### *Per Diem Rate Affected by Class of Service*

This individual practitioner bills basically from a standard per diem rate for his six man staff, but varies his own rate to some extent.

Engagements for almost all of his clients result in audit reports; but his practice also includes corporate tax work and a substantial amount of "management service" work incorporated in his long form reports.

Although lump sum adjustments may occasionally be made (equally up or down), he averages the per diem rate for work on which the standard rate would normally apply.

The normal hourly rates in this firm are:

Junior (beginner) – $5 (business school or two years' college)

Junior (one-two years) – $6

Senior – $8 (average)

Supervisor – $10

Principal – $10 (field work minimum) – $15 (usual)

The time of the clerical staff is charged for at a rate of $3.50 an hour.

In addition to the above rates, the time involved in some types of work is usually billed at double the usual rates, including such things as corporate tax work (no individual returns are prepared except for officers of client companies), pension trusts and profit sharing plans. (The practitioner devotes a substantial proportion of his 1,200 chargeable hours to work in such areas.)

The standard hourly rate for the accounting staff is established by taking the hourly salary being paid to the employee (i.e., 1/2,000 of the annual salary) to which is added an amount equal to 125% of the salary for overhead, supervision and salary for non-chargeable time. Then twenty per cent of the sum of the salary and overhead is added for firm income.

Irrespective of the rates, $25 is the minimum bill which the firm will render (e.g., a conference with a non-regular client). Also, the minimum fee for the preparation of a complete set of corporate tax returns is $250.

Once a bill is rendered, this firm will make no downward adjustments if the client complains about the size of the fee. Its members will take considerable pains to explain the fee, but will withdraw from the engagement if the client insists on the fee being reduced. This situation is minimized by the policy of the firm to give the client an idea of the rough range of the probable fee as soon as possible, and discussing the fee with the client on an interim basis, if the charges are running high.

### *Adjusts Upward from Minimum Rate*

In deciding on an appropriate fee for an engagement, this firm, consisting of two partners, three staff, two clerks, attempts to weigh the value to the client and the amount of technical work involved as well as the amount of time spent. They use a calculated time rate as a minimum guide and adjust upward from it, when circumstances warrant it. The firm confines its activities to auditing and tax work. Only in figuring fees for preparation of tax returns do they consciously take into account the client's ability to pay.

The firm's minimum hourly rate schedule, based on two times the direct labor cost, is: Juniors – $6; Seniors – $8; Partners – $10. The firm often bills 25% higher and sometimes 50% higher than the basic time rate figure would indicate for some services with the greatest fluctuation at the partner level. These adjustments are based on the "in charge" partner's evaluation of the work performed.

This firm has no fixed fee or retainer clients. Most bills are sent annually (e.g., for annual audits) or semi-annually. Since more than 50% of the firm's clients are on a well distributed natural business year basis, the billing level remains fairly steady throughout the year.

Clerical help is charged to the client at $3-4 an hour and travel time is also added to the fee. Only the most extended telephone calls are billed.

The firm usually discusses fees in the initial engagement, especially if the job is comparable to work done for a previous client in a similar type of business.

### *Fees Vary With the Level of Service*

The hourly rates for the eight staff men in this five partner office are established basically by class. These rates are: Juniors – $4-5; Semi-Seniors – $6-7; Seniors – $6-7; Junior Partners – $8; Senior Partners – $10. However, in setting rates, the ability of the individual staff man is taken into account.

The results of the job and financial position of the client are also considerations in setting fees. Although time spent serves as the foundation for calculating a fee, this firm generally makes adjustments from a straight time basis.

Fees for various levels of services vary. Fees for tax work and more difficult assignments are adjusted upward in accordance with the level of the engagement. When a staff man does work normally handled by a lower grade, during periods when he would not be otherwise assigned, it is usually billed at the lower rate.

Fixed fees and retainers are rarely used. The firm attempts to give a client a very rough estimate of the fee or a maximum figure but very rarely mentions hourly rates. The bill is usually sent upon completion of a job. Audit work and tax work are usually billed separately.

Clerical time is not figured separately. Neither is travel time unless it occurs during regular working hours. Charges for business conferences and telephone conversations are determined by the partners for each job and usually only extended conversations are included in the fee.

Discussion of fees varies with clients and type of job. The firm tries to give a new client a rough minimum estimate or an idea of the maximum figure. Any major variations are discussed as the work progresses so the client is kept informed of the costs. The firm seldom mentions hourly rates in these discussions.

### *Three Departments—Three Rate Structures*

"It rarely happens that we bill strictly by accumulated time at the regular rate, except for auditing," says one of the nine partners of a firm which employs about 40 staff men.

The firm operates with three distinct departments, each of which is directed by a senior partner. They are Auditing, Systems & Procedures, and the Tax Department.

The average basic per diem (seven hour) rates for auditing (Juniors – $45; Semi-Seniors – $60; Seniors – $75) are extended for each job but some adjustment for level of engagement and value of work performed are more the rule than the exception. For example, if time runs less than usual for a low level of work performed by a higher grade staff man, the firm bills the higher rate. The partners' hourly charges range from $20 to as much as $50 for infrequent special engagements. The rate for systems specialists is $18-20 per hour and for tax specialists, $20 and up. The basic rates have been established at what the firm feels is the general practice in charging for staff time. Although no formula is applied, the rates are roughly between two and two and a half times the average salary cost in each of the staff grades.

In pre-engagement discussions with a client, the firm gives him some idea of the per diem rate structure and will give a very rough estimate of the total fee if the client insists upon it. If the firm feels that the fee is running higher than the estimate, it is brought to the client's attention early in the engagement.

The firm is retained for a fixed fee by some clients but does not like this practice. Clients for whom special work or systems work is being performed are billed once a month. Tax work is billed on completion. Some regular clients are billed when the report goes out and others are billed annually, although the firm dislikes this method of billing. (This seems to be the consensus of many successful CPA firms. One prominent practitioner in another firm says of annual billing, "I bill yearly only in the case of small audits where the fee is predetermined. I find that this practice minimizes any collection problems which may result from an annual bill where the amount involved is considerable.")

The firm uses a 15 minute billing unit. The decision to charge or not to charge for telephone calls is based on the subject discussed — travel time is charged for only if it occurs during working hours. Clerical time is usually absorbed in general overhead.

### *Summary of Basic Hourly Rates Charged by 22 Firms*

| Staff Class | Actual Range | Usual Practice |
|---|---|---|
| Juniors (0-2 years' experience) | $ 4.50- 7.00 | $ 6.00 |
| Semi-Seniors (3-4 years' experience) | $ 6.00- 8.00 | $ 7.00- 8.00 |
| Seniors (5 + years' experience) | $ 7.00-12.00 | $ 8.00-10.00 |
| Supervisors | $ 8.00-20.00 | $ 8.00-12.00 |
| Principals* | $10.00-25.00 | $15.00-20.00 |

* On certain engagements some firms report that the upper limits would be appreciably higher.

# Appendix A
# Modifications of "Standard" Fees

From time to time unusual elements are involved in engagements (other than taxes) where the practitioner should decide if some upward or downward adjustment to his usual fee is in order. He must then determine the amount of the adjustment to be applied, if such a course is decided upon. One prominent CPA says, "I feel that every bill that goes out must have judgment applied to it after first noting what it might amount to at 'standard' billing rates." Policies of different firms vary in regard to adjusting their fees, but the firms interviewed felt that modifications might be warranted, under certain conditions, for the following reasons:

### *Increase in Fee*

1. An engagement is completed in less than the usual time, because of exceptional effort and familiarity with the problems involved.

2. The results achieved through the work of the firm are unusually good and the value to the client is enhanced.

3. Unusually skillful technical application may have to be employed to achieve the desired result.

4. Substantially increased costs may be anticipated. Some firms make some change to the current bill for repetitive clients so the entire increase will not be charged at one time.

### *Decrease in Fee*

1. Time lost breaking in inexperienced personnel on their assignments, or excessive time when compared to prior years and supervisor or partner feels it can be done in less time the following year.

2. Inadequate supervision or explanation may result in work which need not have been done.

3. Scheduling difficulties may require a higher price man to do work which he can do no better or faster than a lower grade man.

4. Some firms may choose to defer or absorb some of the costs of becoming familiar with a new client's operation.

5. The charges are running higher than the firm led the client to expect and cannot satisfactorily explain them to the client.

### *Cases Where Upward Adjustments Were Made*

(a) The time spent for all personnel on an audit of a corporation selling contracting equipment at retail was 285 hours. In this case the time was slightly under the prior year but the business was larger and the work more difficult. The semi-senior who acted as a senior on the audit had been there twice before and is more than usually rapid. The total of $2,014.25 for time was increased by $189.25 to $2,203.50 to bring the semi-senior up to the $8.50 an hour senior rate. Our bill then went out as $2,225.00 for fee plus $346.93 for expenses, total $2,571.93.

(b) A highly unusual case in our practice is a situation where the client is a corporation doing about two million dollars a year, and in which the entire stock ownership is held by one person who resides and spends most of his time a couple of thousand miles away from the site of the business operations. Our engagement was a continuous audit on a monthly basis. We felt the responsibility assumed by us because of the absence of adequate supervision by ownership warranted our billing at approximately four times our basic minimum rates.

(c) The audit of a retail store in a medium size town resulted in a raw fee, at "standard" rates, of $1,581.50. The managing partner's long experience and special knowledge were used to work out a complicated employment agreement for the general manager. Accordingly his rate was increased to $25 (from the $20 standard) an hour, adding $105 to the total. The semi-senior conducted the work very well and did about as well as any senior would have done. His time was refigured at $8 an hour (two-thirds of the way from the semi-senior to the senior rate). That brought the total time charged to $1,747.25. The bill was made out for $1,750.00 for services plus $208.34 in expenses, total $1,958.34.

(d) The three stockholders of a client corporation had reached a point of violent disagreement, as to how the provisions of an option agreement should be executed in order for one of them to acquire additional shares at what seemed to be bargain prices.

After interpreting the so-called accounting provisions of the agreement, I acted as referee in the negotiations for a compromise. After a continuous all day session with the principals and their attorney, one of several suggestions was agreed upon.

I felt that since (1) I had made an important contribution to the successful existence of the company, (2) the evident satisfaction of the principals with my efforts, and (3) the exhausting nature of the meeting warranted a bill based on double my usual hourly rate of $15.

### *Cases Where Downward Adjustments Were Made*

(a) The junior was slow on the audit of a charitable organization and took over 25 hours longer than any other man had. The work is quite uniform and the audit had been done annually for 30 years, without the fee exceeding $375. We refigured the three and a half hours of the senior partner's time at junior partner field rates and the junior's on the basis of 50 hours instead of 75. That left $432 out of the original figure of $618. This was arbitrarily cut another $22 and the invoice went out at $410. We felt that inflationary pressures justified about a 10% increase over the previous year's invoice.

(b) The engagement was to prepare certified financial statements, for state security-registration purposes, for a newly formed life insurance company about six months after it had started writing insurance policies.

The policies were very intricate — the client's accounting staff was inexperienced — records were inadequate — the company's actuaries were in a different city — and our firm was not very familiar with this field. Extraordinary care was required and exercized and as a final precautionary measure, we asked an accounting firm experienced in the life insurance field to review our work papers and proposed report. This resulted in several changes in accounting treatment and report presentation.

As we went along, we scaled down our rates as best we could to reflect our limited experience in this field and a certain amount of backing and filling. On the other hand, we felt that we had planned and carried on the work intelligently from beginning to end.

When all the charges were added up, the billable amount was about $2,800. We actually reduced our bill almost $800. We felt that on the next similar case, with our increased experience in this field, we could proceed with greater sureness and efficiency and that the reduced time, multiplied by our standard rates, would then be in the neighborhood of $2,000. We did not feel that the first client should pay us for acquiring the experience necessary to handle a similar engagement more efficiently.

(c) In an audit of an automobile dealer with a branch at a distant point, the books, particularly of the branch, were found to be in very bad condition. Because the work had taken much longer than anticipated, even though it was no fault of ours, the 156 hours of the semi-senior's time was figured at junior rates. Even so, the bill came to $4,720 (including expenses and referred work to other accountants near the branch office). This matter was discussed fully with the client before billing. The client had been with us a long time. He recognized the necessity and value of the work but had never had a bill larger than about $2,500 before and he felt it was just "too big" for his business after extended deliberation. We billed at $4,200 which was acceptable and paid. We continue with the client but are now in a position to require our regular rates.

# Appendix B
## Use of Fixed Fees

Over 2,100 offices represented in the Institute membership replied to a questionnaire asking: "Do you have clients on a fixed fee basis?" The affirmative replies do not imply that a fixed fee is the *usual* method employed by these offices, but only that they use them for *some* clients.

On a national basis, 77% of the offices reported that they make use of a fixed fee for certain clients.

Although little regional variation was found in the use of fixed fees, the number of small offices using them was somewhat higher than the national average. The range of fluctuation among the offices of varying size was limited, however.

The national and regional figures for various community and office sizes are shown on the following pages.

## TABLE No. 1

### National Figures by Size of Community

(in thousands)

| | Under 10 | | 10-25 | | 25-50 | | 50-100 | | 100-500 | | 500-1,000 | | Over 1,000 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | No. | % | No. | % | No. | % | No. | % | No. | % | No. | % | No. | % |
| Fixed Fee Used? | | | | | | | | | | | | | | |
| Yes | 116 | 75.3 | 170 | 74.2 | 154 | 75.1 | 153 | 73.2 | 363 | 74.5 | 234 | 78.5 | 423 | 80.3 |
| No | 38 | 24.7 | 59 | 25.8 | 51 | 24.9 | 56 | 26.8 | 120 | 25.5 | 64 | 21.5 | 104 | 19.7 |
| Total | 154 | 100.0 | 229 | 100.0 | 205 | 100.0 | 209 | 100.0 | 483 | 100.0 | 298 | 100.0 | 527 | 100.0 |

## TABLE No. 2

### National Figures by Size of Office

| **No. of CPAs** | 1 | 1 | 1 | 2-4 | 2-4 | 2-4 | 2-4 | 5-9 | 5-9 | 5-9 | 10 or more |
|---|---|---|---|---|---|---|---|---|---|---|---|
| No. of Staff* | 0-1 | 2-9 | Total | 0-1 | 2-4 | 5+ | Total | 0-4 | 5+ | Total | Total |
| | % | % | % | % | % | % | % | % | % | % | % |
| Fixed Fee Used? | | | | | | | | | | | |
| Yes | 81.5 | 88.5 | 83.8 | 79.5 | 76.3 | 75.4 | 77.3 | 73.3 | 68.3 | 69.5 | 72.3 |
| No | 18.5 | 11.5 | 16.2 | 20.5 | 23.7 | 24.6 | 22.7 | 26.7 | 31.7 | 30.5 | 27.7 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

* Refers to non-certified staff members.

## TABLE No. 3

### Regional Figures by Size of Community

(in thousands)

| | Under 10 | 10-25 | 25-50 | 50-100 | 100-500 | 500-1,000 | Over 1,000 | Regional Total |
|---|---|---|---|---|---|---|---|---|
| NEW ENGLAND, MIDDLE ATLANTIC & NORTH CENTRAL | | | | | | | | |
| Fixed Fee Used? | | | | | | | | |
| Yes | 69.8% | 71.4% | 78.9% | 73.3% | 73.6% | 75.6% | 82.3% | 77.2% |
| No | 30.2 | 28.6 | 21.1 | 26.7 | 26.4 | 24.4 | 17.7 | 22.8 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| SOUTHEAST, SOUTH & SOUTHWEST | | | | | | | | |
| Fixed Fee Used? | | | | | | | | |
| Yes | 88.0% | 72.1% | 67.2% | 77.6% | 76.6% | 77.6% | 83.3% | 76.6% |
| No | 12.0 | 27.9 | 32.8 | 22.4 | 23.4 | 22.4 | 16.7 | 23.4 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| WEST CENTRAL, GREAT PLAINS & MOUNTAIN | | | | | | | | |
| Fixed Fee Used? | | | | | | | | |
| Yes | 69.2% | 73.5% | 79.4% | 62.1% | 75.4% | 73.9% | 72.2% | 72.8% |
| No | 30.8 | 26.5 | 20.6 | 37.9 | 24.6 | 26.1 | 27.8 | 27.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| PACIFIC COAST | | | | | | | | |
| Fixed Fee Used? | | | | | | | | |
| Yes | 68.2% | 83.7% | 78.8% | 73.7% | 75.0% | 88.1% | 76.9% | 78.4% |
| No | 31.8 | 16.3 | 21.2 | 26.3 | 25.0 | 11.9 | 23.1 | 21.6 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

# Appendix C
## Usual Basis for Setting Fees

The following tabulation, by office size, represents the distribution of the various criteria usually employed by 2,100 accounting offices in determining their fees.

| **One CPA** No. of Staff* | 0-1 | 2-9 | Total |
|---|---|---|---|
| Time spent | 18.5% | 23.5% | 20.2% |
| Time spent with adjustments for circumstances | 40.3 | 37.9 | 39.5 |
| Special rates for tax work, time spent for most other | 23.0 | 22.9 | 23.0 |
| Depends on the engagement and the circumstances | 18.2 | 15.7 | 17.3 |
| Total | 100.0 | 100.0 | 100.0 |

| **Two-Four CPAs** No. of Staff* | 0-1 | 2-4 | 5 or more | Total |
|---|---|---|---|---|
| Time spent | 20.0% | 20.0% | 23.3% | 20.4% |
| Time spent with adjustments for circumstances | 43.7 | 38.0 | 36.4 | 39.9 |
| Special rates for tax work, time spent for most other | 23.7 | 25.7 | 30.2 | 25.6 |
| Depends on the engagement and the circumstances | 12.6 | 16.3 | 10.1 | 14.1 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |

| **Five and Over CPAs** No. of Staff* | 5-9 0-4 | 5-9 5 or more | 5-9 Total | 10 or more Total |
|---|---|---|---|---|
| Time spent | 19.1% | 21.5% | 20.5% | 21.2% |
| Time spent with adjustments for circumstances | 47.9 | 45.4 | 46.5 | 40.4 |
| Special rates for tax work, time spent for most other | 18.1 | 20.8 | 19.6 | 28.8 |
| Depends on the engagement and the circumstances | 14.9 | 12.3 | 13.4 | 9.6 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |

* Refers to non-certified staff members.

## Subject Index